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UNCLAS SECTION 01 OF 02 COLOMBO 001448

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DOC FOR JFERNANDEZ, ASTERN

E.O. 12958: 08/06/12
TAGS: ECON PREL ETRD CE ECONOMICS
SUBJECT: ECONOMIC REFORMS

Ref: Colombo 561

¶1. (U) Summary: In its eight months in power, Sri Lanka's UNF government has made measurable progress on one of its main goals, economic reform, with efforts starting to show real results over a broad range of promised actions. The true tests will be action on pending economic legislation and implementation of difficult measures. End summary.

THE MEANS

¶2. (U) To spark growth and rein in the deficit, the UNF's March 2002 budget incorporated tax reforms, realignment of investment incentives, privatization, removal of subsidies, deregulation, and pension and labor reforms (reftel). New laws are required for many proposed measures, and economic-related drafts comprise the majority of the thirty-six new bills on the docket for an extended August/September parliamentary session. Parliament will consider laws or amendments on fiscal responsibility, revenue authority, bank rescue, IPR, financial sector revamping, the monetary law, the electricity act, and pension supervision, among others.

¶3. (U) To carry out economic reform measures, the government is using a variety of tactics. Leading the effort is the Policy Development and Implementation Ministry, a small group headed by the Prime Minister, that operates largely behind the scenes with personnel brought in from UNF's previous administrations and foreign (including US) advisors. Also, experienced Sri Lankans have been lured back from abroad to take key governmental positions. After conferences on two major issues, deregulation and financial sector reform, public/private sector working groups were established to advise on implementation. In some cases, consultations are held with involved parties, e.g., the Minister of Employment and Labor met regularly with employers, unions and government officials before drafting wide reaching reform legislation. The government has also contracted world class marketing firms for a public information campaign to sell its most controversial (e.g., privatization and tax) measures.

TO THESE ENDS

¶4. (U) The GSL has already implemented promised changes in many areas. It has made upward adjustments of utility, transport, wheat flour and fuel prices, eliminating subsidies. One hundred percent foreign ownership is now allowed in sectors formerly restricted, including banking, insurance, finance, and supply of water, mass transport, telecom and professional services. Long term debt instruments have been added, increasing the maximum term treasury bonds from 6 years to 12 years. Incentives offered to investors under the Board of Investment were restructured and reduced. Civil service recruitment is frozen. Licensing controls on rice, potatoes and onions were removed, leaving these food items with only a duty.

¶5. (U) Privatization: Real progress has been made in privatization of state-owned enterprises. The government is moving to reach its goal of Rps. 21 billion (approx. $219 million) in privatization proceeds by year's end. The largest privatization this year was the sale of Lanka Marine Services, the bunkering arm of Ceylon Petroleum Corporation, for Rs. 1.2 billion (approx. $12.5 million). The government has sold the residual stakes of two regional plantation companies through the Colombo Stock Exchange. Two sugar mills were sold to local investors, and a Cabinet decision is pending on a third. The results of a tender to privatize 50 percent of the bus transport system are expected in early September. The GSL has announced the sale of two insurance companies, including Sri Lanka Insurance Company, the largest player in the market. There are plans to sell an additional 15 percent of Sri Lanka Telecom (out of the 65 percent still government-held) in October. The GSL's 49 percent equity in Shell Gas Lanka will also be sold later this year.

¶6. (U) Tax reforms: Major tax reform was implemented with

the introduction of a Value Added Tax (VAT) on August 1. The VAT replaces the GST of 12.5 percent and the National Security Levy of 6.5 percent, and is expected to simplify the tax system and improve tax administration. Local wholesale and retail activities, and exports are exempt from VAT. The VAT has reduced the number of exemptions under the former system, expanding its regime, but a significant portion of private consumption is still protected. In addition to VAT, the GSL introduced a 0.1 percent tax on bank debits, and a 10 percent tax on interest. The import duty surcharge was reduced from 40 to 20 percent, a 25 percent customs fee was lifted, and the one percent stamp duty was eliminated. The cost to the government of VAT exemptions was recently estimated at Rps. 800 million ($8.33 million). The revenue from the tax on interest payments, however is expected to net Rs. 5.7 billion ($59.4 million) more than forecast.

¶7. (U) International Financing Institutions' support for the government's reforms efforts is strong. The ADB and World Bank have programs in Central Bank restructuring, legal and judicial reforms, economic reforms technical assistance, and public sector resources management. USAID-funded consultants are providing assistance in the public information campaign, and in economic and productivity policy development. Support is also seen from local firms, who are beginning to upgrade and expand, after a period of subdued activity preceding and following the December elections.

¶8. (SBU) Comment: The way forward for the GSL is clear, but will not be smooth. The government has already felt compelled to respond to public complaints about the rising cost of living associated with the removal of subsidies, by lifting a cost-recovery charge on fuel. The hinted-at restructuring of a state-owned bank has provoked protests from unions, as have some privatization plans. If the GSL does follow through on these plans, and the proposed labor reforms, a stronger social safety net to help those displaced by these measures must be in place.

¶9. (SBU) Comment continued: Political will to carry through reforms seems firm at the top, and is the key reason for results achieved so far. US support for continued strong leadership on economic reforms could strengthen the GSL's resolve. Lack of technical expertise, a bloated and inefficient public sector and the entrenched culture of delays, opacity and personal agendas hinder the efforts in implementation. More importantly, a derailment of the peace process or political disruption caused by infighting in the government could stop the momentum. End comment.

Wills